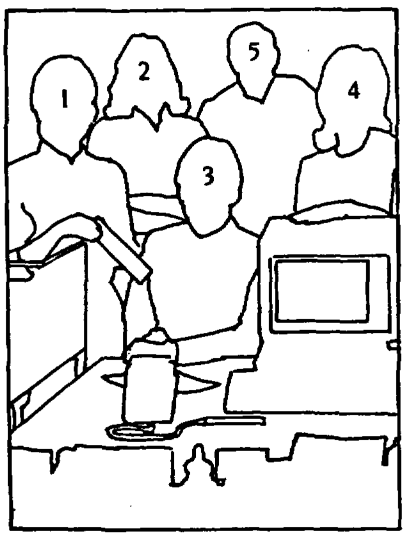
Mass Merchandisers, Inc. 1984 Annual Report

189125

Corporate Profile

Mass Merchandisers is the nation's leading service merchandiser distributing nonfoods to supermarkets, drugstores and other retailers. Our 16,000-product line is the most complete in the industry, and our customer base of 11,000 accounts is believed to be the broadest. As we discuss in this report, however, Mass Merchandisers' strengths extend far beyond those basic facts.



Cover photo: Mass Merchandisers, Inc (MMI) distributes 16,000 nonfood products to ~~food and drug~~ retailers in 32 states. MMI's valuable ~~employees use their~~ initiative and innovation along with the latest in computer technology, warehousing systems and a fleet of tractors and trailers to effectively serve MMI's customers from Montana to Florida. A shopper and MMI employee (1) Cheri Marks begins the order cycle with a purchase. (2) Cindy Allen fills the orders in the Harrison warehouse; (3) Ronnie Honeycutt, our sales person, services the store. (4) Beverly Austin is one of MMI's computer programmers and (5) Glen Paul, our truck driver, delivers the merchandise. For an explanation of the MMI order cycle, see the pictures and captions which begin at the top of page 2.

■ Goals
Sales and earnings growth in the 15-20 percent range are targeted through the next several years as proven strategies continue to add to our market position. New facilities and marketing programs are the tools for profitable growth. At the core of our operations is a basic concept: No one is more important than our current customers. Goals and outlook are discussed further in the Shareholder Letter, Page 2.

■ Opportunity
In their efforts to build profitability, retailers are opening larger stores — and increasing the percentage of shelf space devoted to nonfoods. Nonfood sales, as a result, are expected to continue to grow at a much faster rate than food sales in the years ahead. Larger, more sophisticated customers are demanding the product lines, service levels, pricing and support that Mass Merchandisers is able to provide effectively. To maximize profitable growth, Mass Merchandisers' strategy is to increase penetration of existing customers and territories, enter new territories with limited commitment of capital and pursue acquisitions selectively. Details of our market opportunities and the way we are capitalizing on them are included in the Growth Strategy, Page 4.

■ Innovation
From the satellite distribution system that maximizes service levels to the new purchasing programs that help minimize costs, the operating emphasis throughout the Company is to serve the customer better, faster and with less expense. These programs build total corporate profitability, improve management control and planning capability, and ensure customers of performance well above industry standards. All are covered in the Operating Strategy, Page 7.

■ Performance
Pretax margins increased to 3.2 percent in 1984 from 2.6 percent in 1983. Net earnings from continuing operations rose 46 percent on a 17 percent increase in sales and earnings per share increased 45 percent from $.56 to $.81. Return on equity rose to 12.9 percent in 1984, versus a near-term goal of a 16-18 percent return that we hope to achieve in the next few years. Mass Merchandisers' financial strategy is discussed in the Financial Review, Page 11.

Contents (continued)

Financial Highlights

	1984	1983*	Percent Change
	(dollars in thousands except per share data)		
For the Year			
Net revenues	**$326,300**	$278,452	17.2%
Net earnings from continuing operations before income taxes	**$ 10,553**	$ 7,215	46.3
Net earnings from continuing operations	**$ 5,540**	$ 3,802	45.7
Net earnings	**$ 5,498**	$ 4,183	31.4
Net earnings per common share from continuing operations	**$ .81**	$ .56	44.6
Net earnings per common share	**$ .81**	$ .62	30.6
Dividends per common share	**$ .174***	$ .216	-19.4
Return on average stockholders' equity	**12.9%***	9.8%	31.6
At End of Year			
Working capital	**$ 32,534**	$ 26,710	21.8
Total assets	**$123,452**	$114,002	8.3
Long-term debt	**$ 27,065**	$ 25,386	6.6
Stockholders' equity	**$ 45,581**	$ 40,510	12.5
Common stockholders' equity per share	**$ 6.55**	$ 5.91	10.8
Common shares outstanding (000's)	**6,814**	6,694	1.8
Number of common shareholders	**3,066**	3,060	0.2
Number of employees	**2,378**	2,065	15.2

*Amounts are based on results, assets, liabilities and stockholders' equity of continuing operations only. Shares outstanding, dividends and earnings per share have been adjusted for the 676,000 shares issued to Napco International Inc. in the May 1, 1984 corporate reorganization.

Corporate Highlights

February 1985 — Record sales and earnings from continuing operations are reported for 1984.

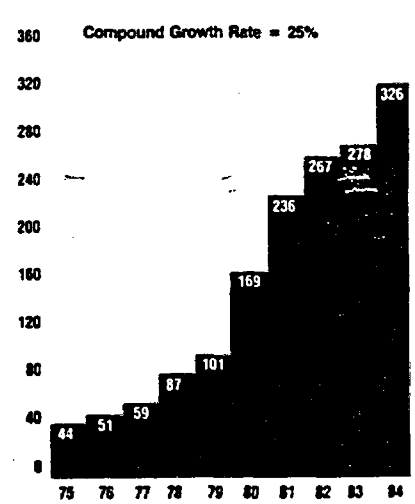
November 1984 — Expanded satellite ware~~house is~~ dedicated at Ozark, Alabama. The 110,000-square-foot expansion is part of the Company's growth strategy for the southeastern United States.

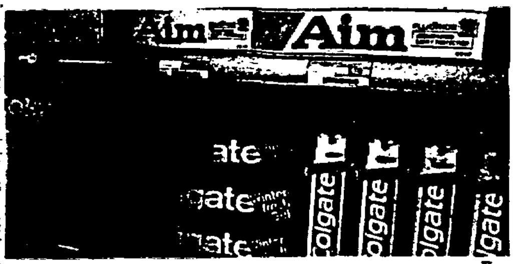
November 1984 — The first phase of a highly sophisticated purchasing system is implemented to accommodate continued sales growth and strengthen management planning capabilities.

September 1984 — Ground is broken for a 200,000 square-foot facility to support the Company's increased emphasis on promotions, a sales segment that doubled in 1984.

May 1984 — Napco Industries spins off its international marketing group as a separate company, and changes its name to that of its remaining operating unit, Mass Merchandisers, Inc.

Net Revenues
(Millions of Dollars)





45 a.m., Monday
Lakeland, Florida

Fellow Shareholders:

During the past year major achievements were made at Mass Merchandisers. We posted record sales and earnings. We entered new markets. Through the spinoff of our international marketing group, we clarified our identity among investors, customers and employees.

Most important, the steps we have taken to strengthen our internal controls, profitability and market position are bringing new confidence in our prospects for continued strong growth. Throughout this report, we will be discussing not only the operations of our company, but also the strategies and strengths that we are bringing to the market to help us achieve our goals.

A Plan For Growth

As we discuss the growth potential of Mass Merchandisers, it is important to stress a singular emphasis that is essential to our success: *"There is no one more important than our existing customers."* No new account, no cost-saving program, no strategy component is more important to us than making sure our current customers are receiving all the service, support and attention they deserve. We will not be complacent or take our present customers for granted.

This singleminded loyalty to existing customers helps us develop the services that also make us attractive to new customers. It is by staying in close contact with our customers that we recognized the importance of helping retailers adapt to optical price scanners and other computerized systems. It is by responding to our customers' needs that we have created an operating system that maximizes both efficiency and flexibility. It is through our broad product selection and our merchandising expertise that we help our customers become more profitable, and thereby we become attractive to potential customers who share that goal.

Thus, the first emphasis of our growth strategy is internal growth: increased sales to existing customers. As we discuss in the pages that follow, our strategy also includes deeper penetration of existing territories, selective expansion into new territories, increased participation as the nonfood arm of major supermarket chains and wholesale grocers, acquisitions, expanded promotion programs and a new market thrust into discount stores.

We are positioning ourselves through expansion programs that increase our distribution capacity. To serve our growing customer base in the southeastern United States, we added 110,000 square feet to our Ozark, Alabama satellite warehouse, completing that $2 million expansion in November. About the same time, we broke ground for a 200,000 square-foot addition to our main distribution center in Harrison, Arkansas. This $4 million facility is designed to accommodate our growing participation in promotional programs. Placing a new emphasis on special promotions in 1984, we doubled our promotion sales. Completion of the warehouse facility in mid-1985 will enable us to build this marketing effort further and handle the increased volume more efficiently.

Results of Operations

As we reported throughout the year, Mass Merchandisers added new customers and built sales to existing customers which resulted in record sales and earnings in 1984. By maintaining strong operating controls, we were able to build performance in many critical areas, including pretax margins, net margins, asset turnover and return on equity.

Net earnings from continuing operations increased 46 percent to $5,540,000 or $.81 per share, from $3,802,000, or $.56 per share, in 1983. Net revenues increased 17 percent to $326,300,000 from $278,452,000. Significantly, customers added in the past year have increased the base on which future growth is built, making us optimistic about our prospects for 1985 and the years ahead.

A consumer begins the order cycle for products M[illegible]stributes with a purchase of Colgate toothpaste An example of the order cycle follows at the top of the following pages

Continuing operations exclude the international marketing group of Napco Industries. Inc., which was spun off in May, 1984 as Napco International Inc., a separate, publicly held company. Mass Merchandisers, the sole remaining operating segment of Napco Industries, was then merged into the parent company, which was then renamed Mass Merchandisers, Inc The split resulted from an effort to clarify the identity of both businesses and allow each company to be more flexible in pursuing its business opportunities and strategies

Goals and Outlook
Our continued growth results from programs instituted during the past two years to achieve our full potential as the nation's leading service merchandiser distributing nonfood items to supermarkets, drug stores and other retail outlets. It is a tribute to the dedication and innovation of all our employees that we have been able to accomplish so much so quickly Based on our market position, strategies and industry growth outlook, we believe we can build revenues and earnings at a 15-20 percent annual rate in the years ahead, excluding the impact of major acquisitions

We achieved great progress toward our long-term profitability goals in 1984 with pretax margins increasing to 3.2 percent from 2.6 percent in 1983 This improvement allowed us to increase our return on average stockholders' equity to 12.9 percent from 9.8 percent in 1983 after giving effect to the spinoff. Return on equity is our primary management emphasis for 1985 and the years ahead We hope to reach our near-term goal of 16-18 percent return on equity within two years, and we will strive for further improvement in the future

One of the major achievements of the past two years has been the increased effectiveness of our control systems. Critically important, this emphasis on management control has been implemented by upgrading our information systems and company-wide communications — not by adding a bureaucracy that builds response time.

Our strategies have been fully discussed and analyzed at all levels of Mass Merchandisers' operations Management has focused its energies on coordinating and implementing these strategies effectively to reach our goals. And our full staff is committed to their achievement. We believe we will be able to report to you at this time next year that these efforts have yielded another year of solid, profitable growth for Mass Merchandisers

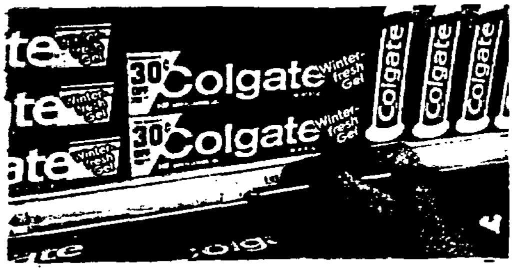
Sincerely,

Frank D. Trestman
Chairman

J.D. Erwin

J.D. Erwin
President

Frank D Trestman, left, and J D Erwin



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Lakeland, Florida

Growth Strategy

Roger Ladd, left, Vice President - Marketing and Trade Relations, and John Porter, Vice President - Southern Sales

Mass Merchandisers' outlook for continued growth is based on three favorable factors: industry growth, our current market position and proven company strategies.

The Market

In 1983 approximately $20 billion of the $264 billion dollar grocery store market was derived from the sale of nonfoods — health and beauty aids and general merchandise items. A like amount of nonfood sales was generated by drugstores, discount stores and other retailers combined.

In the supermarket segment, nonfood sales offer compelling indications of long-term growth. This major segment enjoyed an overall sales increase of 4.7 percent in 1983, while nonfood sales in supermarkets grew at more than 9 percent, or approximately twice as fast.

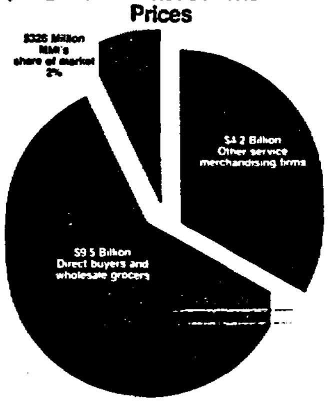
Food sales tend to increase with population growth and, because supermarkets already account for most of the food consumed in the United States, the opportunities for supermarkets to gain market share are limited. Nonfoods, however, are growing at a faster pace. According to *Progressive Grocer* magazine, health and beauty aid sales increased at a 9.7 percent rate in 1983. That same year grocery stores accounted for 47 percent of all health and beauty aid sales, a 2.7 percent share increase over 1979, and leaving ample opportunity to build further market share.

Nonfoods also offer superior profit margins while generating an average 8 percent of all food store sales. Nonfoods can contribute as much as 50 percent of store profits in very large supermarkets and combination stores. Thus, compared with the food industry in total, nonfoods offer superior growth, market share and earnings potential.

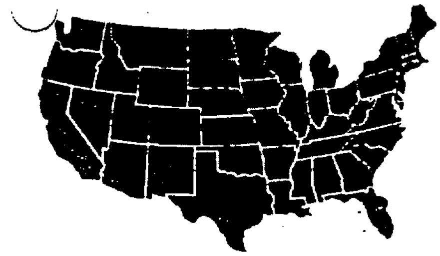
At the same time, supermarket operators increasingly are recognizing that their expertise in food sales does not translate directly to the lower-turnover, higher margin nonfood items. As a result, Mass Merchandisers and other service merchandisers have expanded their role as supermarket suppliers. A recent survey by the National Association of Service Merchandisers indicated that member firms grew at an average rate of 16.8 percent in 1983, more than triple the 4.7 percent rate of growth experienced by supermarkets. Service merchandisers accounted for approximately one-third of the estimated $14 billion (at wholesale prices) in nonfoods sold through foodstores last year. Direct buyers and grocery wholesalers represent the balance of $9.5 billion and they represent another important area of potential growth for service merchandisers.

It is expected, however, that fewer competitors will be vying for that market as consolidation continues among service merchandising firms. Most service merchandisers are small, limited line operators and, because new technologies and automation of

Nonfood Sales In Food Stores
$14 Billion Market at Wholesale Prices



MMI's sales person restocks our customer's shelves with the most recent order then reorders items which are in low supply



distribution systems play a large part in maintaining profitable operations, it is believed many small competitors will leave the market or be acquired.

The trend to larger store formats is seen accelerating this process. These larger stores demand product breadth and service beyond the capabilities of most service merchandisers. The July 1984 issue of *Progressive Grocer* stated, "Superstores and combos represent the leading edge of supermarketing and while they give food its due, these jumbo units also provide general merchandise with a far greater proportion of space than in conventional stores." Expansive product selection and service capability are, therefore, a primary requirement for service merchandisers in meeting the needs of this growing market segment.

Market Position

Mass Merchandisers' position as the leading service merchandiser in its industry has enabled it to meet the growing needs of its customers. This has been particularly true for the giant superstores, combination stores and warehouse stores that are building an increasing share of the supermarket industry. From just 1,000 stores in 1976, these formats now total over 6,500, and they devote an above-average percentage of their shelf space to nonfoods.

Mass Merchandisers is one of the few service merchandisers with a broad enough product line and sufficient operating capacity to serve these giant stores. Consequently, superstores, combination stores and warehouse stores are a growing segment of our sales base. And, our existing customers are opening more of these large store formats than conventional supermarkets.

The same product and service strengths that have made Mass Merchandisers a major supplier to these giant stores are expanding the company's role as the nonfood partner of major food wholesalers and supermarket chains. Just as individual supermarket operators have recognized the profit contribution offered by Mass Merchandisers services, a large number of grocery wholesalers also rely on us to distribute nonfoods to their customers.

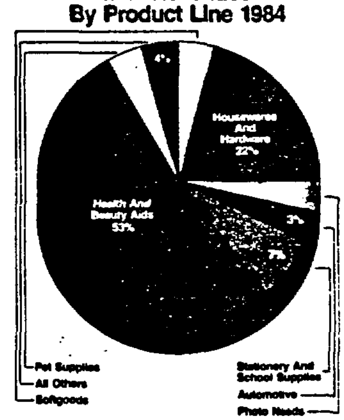
Much of Mass Merchandisers' sales are in the Sunbelt states, the nation's fastest growing areas. In 1984, over 50 percent of our sales were within the Sunbelt, and we see continued growth in this region in the years ahead.

Growth Strategy

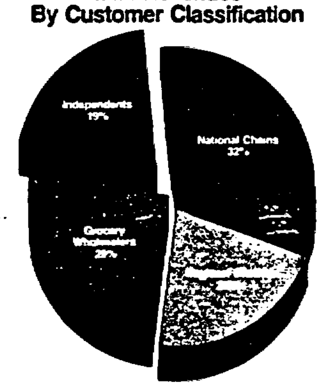
Mass Merchandisers has adopted a strategy for growth designed to yield sales increases that strengthen overall corporate profitability. Within that strategic approach, several key tactics are being employed to build our market position.

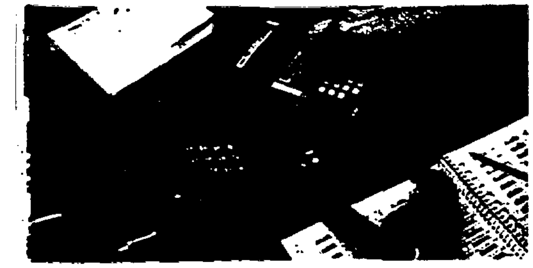
• Existing Customer Growth. Current customers offer the strongest opportunities for new sales. In particular, increasing our product categories within existing customer stores is being em-

MMI Revenues By Product Line 1984



MMI Revenues By Customer Classification





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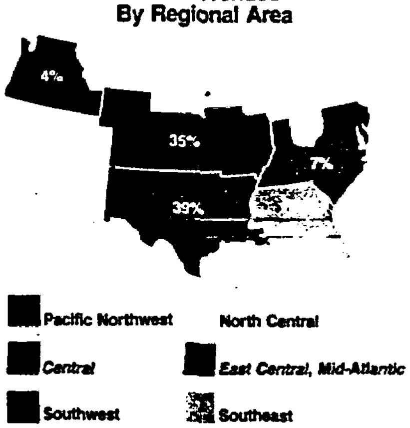
Tampa, Florida

MMI Revenues
By Regional Area



phasized throughout our sales organization. Growing with our customers as they enlarge their stores will also increase our future sales.

An expanded emphasis on promotions in 1984 already has proven to be an effective tactic in increasing sales. Promotions, usually bought in large quantity and sold at attractive prices, create incremental sales and profit opportunities for retailers, and this helps strengthen customer relationships. At the same time, offering these special promotions through existing marketing channels adds relatively little to our incremental costs.

• Market Penetration. A second portion of our effort to build sales profitability involves deeper penetration of existing market areas. We can serve new customers efficiently from our current distribution system, with minimal investment in inventory and staffing. Our present customers include many of the nation's fastest growing supermarket chains, so our broad product selection, merchandising skills and strong service levels can translate into additional business as these chains add new stores.

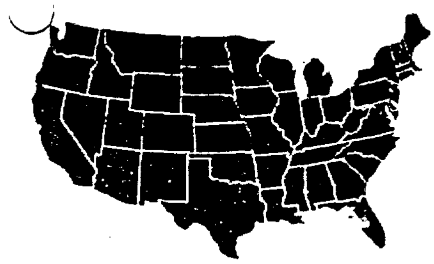
• Geographic Expansion. New opportunities are being pursued just outside our existing service areas, enabling us to serve customers in those regions from our existing distribution centers. New markets are entered through a key customer, often a chain we are serving elsewhere in our territory. By providing exceptional service to that retailer, we attract other customers. The company's expansion into Florida, building sales in that state from $9 million in 1981 to $25 million in 1984, is a prime example of this cost-effective approach to geographic expansion. *The expansion of our Ozark,* Alabama distribution center in 1984 resulted from existing demand and from further potential growth. The Texas market currently offers similar opportunity.

• Acquisitions. Selective acquisitions of other service merchandisers within our existing market areas are another component of growth. Just as it is most effective to build sales with our existing customers, acquisitions can yield new sales quickly with low marketing and development costs per dollar of sales.

• New Markets. While the bulk of Mass Merchandisers' sales are directed to supermarkets and drugstores, the discount store market offers substantial opportunity. Discount stores represent a virgin market superimposed over our existing service territories. Even though discount stores have strong retailing expertise, we believe our product breadth, merchandising skills and distribution capabilities can be valuable to these large retailers.

Based on our strong position in the marketplace, the positive aspects of the nonfoods business and the successful implementation of our strategies, we are optimistic for continued growth for both sales and earnings.

Our sales person transmits his order to Harrison, Arkansas via a special telephone modem



Operating Strategy

Being the leading service merchandiser of nonfoods to the supermarket industry has distinct advantages. Our size gives us purchasing power with the nation's largest suppliers of health and beauty aids and general merchandise items. With our 16,000 products directed at our broad customer base, we are not vulnerable to individual product changes or the product line preferences of a single account. Generating over $300 million in yearly sales, we have ample opportunity to cover our investment in highly efficient facilities and advanced data processing capabilities.

But size isn't enough to guarantee profitable growth. Rather, the same critical strengths that generate growth for any company — innovation, productivity and customer service — are the factors pursued by Mass Merchandisers for our future strength. Throughout our operations, from the order filling lines to data processing, we encourage our people to keep their attention on the customer, and to find innovative ways to serve that customer better, faster and with less expense.

The examples that follow reflect that approach. ~~Some~~ of the efforts are longstanding successes. Others are now being implemented to provide improved performance for years to come. All are evidence of the innovative approach that has helped make Mass Merchandisers the leader in its industry.

Distribution

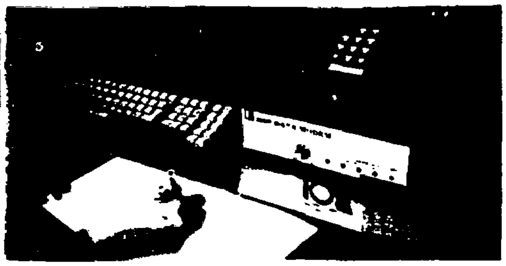
Mass Merchandisers' satellite distribution network is unique in the service merchandising industry, handling some 220 million individual items in 1984. Of our 16,000 products, approximately 3,000 are stocked and distributed by regional distribution centers in Harrison, Arkansas; Lincoln, Nebraska; and Ozark, Alabama. These are the highest volume items that account for approximately 70-75 percent of our sales. From the satellite distribution centers, delivery of the most frequently ordered items is initiated within 24 to 48 hours.

The remaining 13,000 products, which provide about 25 to 30 percent of sales, are stocked and distributed from our extended item warehouse in Harrison, Arkansas. This centralized distribution system enables us to minimize inventory investment in the slower moving items, while maintaining high service levels to our customers.

Service levels, as measured by the percentage of any order that can be delivered immediately, are a major factor in nonfoods profitability for retailers. Mass Merchandisers aims for — and meets — a 95 percent service level overall, well above the industry average. The service level of key items is near 100 percent. In the high-volume supermarket industry, Mass Merchandisers' superior service levels can result in incremental profits for retailers.

Current and planned sales

Robert Keeter, left, Vice President - Distribution. Bob Barker, center, Vice President - Support Services. Dempsey Starkey, right, Harrison Distribution Center Manager



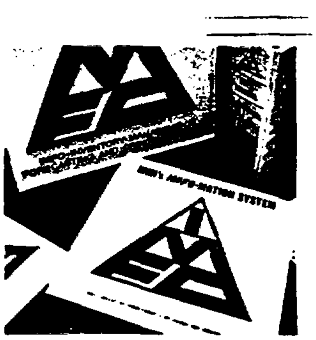
5:21 p.m., Monday
Harrison, Arkansas

growth in our present sales territories has enabled us to expand our distribution capacity at our existing locations in a cost-effective manner. The 110,000 square-foot expansion of the Ozark, Alabama facility in 1984, for example, entailed an investment of $2 million. The low cost Ozark expansion, completed late in 1984, was comprised mostly of new inventory storage space and racking systems. The expansion was needed two years earlier than expected due to rapid growth of our customer base in the Southeast.

David Roth, left, Director of the IMFO Project; Tom Teaster, right, Vice President - Merchandising and Promotions, and Darrell Wilson, seated, Vice President - Health and Beauty Aid Purchasing.

In September 1984, Mass Merchandisers broke ground to build a 200,000 square-foot addition at Harrison, primarily to accommodate further expansion of the successful promotion programs undertaken in 1984. The expansion, which includes a 46,000 square-foot mezzanine, is also designed to upgrade our returns processing function, consolidate our merchandising department and add backup storage capacity. This facility is expected to be completed in mid-1985 at a cost of approximately $4 million.

Mass Merchandisers builds profitability without adding to customer costs by finding innovative ways to reduce internal costs. Our fleet of 115 trailers backhauls shipments from suppliers, sharply reducing freight expense and increasing our control over incoming merchandise.



Our trailers are carrying more product — and less air — than in the past, thanks to a new "tote box" delivery container that matches more closely the requirements of smaller size customer orders. This new tote box, designed by our operations management, allows us to load about 10 percent more product per trailer. The smaller container helps us reduce the number of trailer trips and breakage, improving both costs and service.

Purchasing

The common wisdom usually says: If it isn't broke, don't fix it. But uncommon wisdom requires a continual upgrading of operating systems to provide efficient, profitable growth. Such is the case in purchasing, where a new computerized management information system is being developed to further upgrade an already highly productive operation.

Reflecting the emphasis on total corporate performance, the strategy of the purchasing department is maximum profitability. The 21 buyers and product managers at Mass Merchandisers must ensure that inventories are sufficient to meet our superior 95 percent service level. At the same time they must keep those inventories trim enough to turn rapidly, while also minimizing product costs.

To accommodate those goals and continued growth over the long term, the department is implementing the Inventory Management Forecasting and Ordering System (IMFO). This customized inventory management and scheduling system is of the type widely used by manufacturing firms. Mass Merchandisers is one of the first, if

The order is received in Harrison, Arkansas to be processed along with other customer orders by MMI's mainframe IBM 3083-J. The computer then plans the following day's work schedules for each of our warehouses.

not the first, among distribution companies to utilize this state-of-the-art management tool. The new system, which is being installed in several phases, is designed to provide substantial cost and service benefits to Mass Merchandisers, its customers and suppliers. Used effectively, the system should:

• Increase purchasing productivity by automating many of the clerical and computing functions that now require individual attention of buyers and product managers so that they can spend more time reviewing new products, merchandising programs and sales programs.

• Improve the performance of our suppliers by sharing our long-term ordering schedules with them, ensuring that goods will be available to us, and our customers, at the right time and at the best possible prices.

• Establish a more flexible management information system for use in corporate budgeting, cash flow projections and warehouse space planning. Management will be able to simulate the factors involved in opening or closing facilities, adding major new customers and altering distribution patterns.

The system is designed for maximum flexibility. While forecasts are generated on the basis of the past 36 months' sales patterns, for example, the computer programs allow adjustments to reflect management insight, additions to the customer base, seasonal patterns and so on.

The forecasting and inventory management systems already are in place, and the entire system is expected to be completed in late 1986. When fully implemented, the system will be accessed by personnel throughout the company to manage the business and better serve our customers.

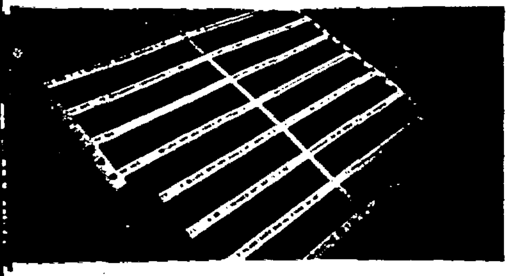
Data Processing
Mass Merchandisers' customers range from local supermarkets buying $1,000 per week of non-foods to major chains having annual purchases in the millions, and the data processing department's challenge is to help all of those customers improve their performance.

The challenge is met via a system that creates customized reports on changes in prices, product specifications and suggested retail prices. The challenge is met by preparing those reports in the way the customer wants them: computer-to-computer, computer-to-controller, printed reports or computer tape. The challenge is met by making sure the customer always has accurate information on a timely basis.

Timing is critical when manufacturers raise prices, or when new products are introduced. Shelf labels, notices to customers and updates of electronic scanning equipment data files all must be completed quickly to maximize retailer sales and profitability.

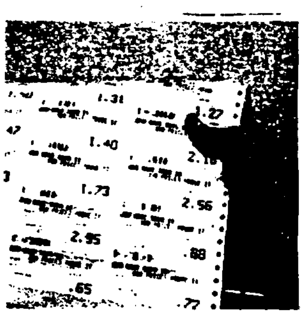
Through our data processing capabilities, Mass Merchandisers has become the industry's foremost provider of support for

Bob Willey, left, Director of Data Processing Operations and Systems. Ken Savells, center, Director of Data Processing Applications Development, and Dave Hampton, right, Vice President - Information Systems



12 Midnight, Monday
Harrison, Arkansas

Junior Bandy, seated, Controller, and Roger Koenecke, Vice President - Finance



retailers who use electronic scanning equipment. And we are determined to retain that position, by providing more sophisticated product movement and merchandising information to our scanning customers in the future. In 1984, Mass Merchandisers electronically updated scanner devices for customers responsible for approximately 25 percent of our sales volume.

With 30 programmers designing integrated software for our operations, and 1.6 percent of revenues devoted to the information systems area overall, Mass Merchandisers has achieved major goals in recent years. As in purchasing, the data processing department organizes its systems to maximize overall corporate performance. The various computer programs are integrated through data base management systems.

The system prints out shelf labels that are read electronically by Mass Merchandisers' salespeople as they prepare new orders at a supermarket. The data from the shelf labels, or alternatively from bar-coded order books, are transmitted electronically to the computer center in Harrison, where the computer determines from which warehouse the orders are to be filled. It then generates a series of price stickers — sequenced in the order that they will be picked off the racks in each of the warehouses.

The system, which contains our product sales history, enables salespeople to identify the specific products and shelf layouts that will improve profitability for new customers. This ability to project results based on real, long-term performance statistics is a significant tool in attracting new customers. Also important is the system's ability to prepare the shelf labels, scanner support and other customer start-up services in far less time than competitors — a major advantage in accommodating new store openings and remodeling.

Thus, the system improves inventory planning for customers, helps them update their prices and other records, provides them with pre-priced goods, speeds up the delivery cycle and minimizes paperwork — each helping them to optimize their profitability. Internally, it also adds a sophisticated component to our management information systems by permitting gross profit analyses in a variety of formats.

Besides the major program to upgrade purchasing systems, the data processing effort will be adapted in the future to automate the processing of merchandise returns, utilizing laser scanning, and to tie personal computers in sales offices into the main computer for certain ordering and analysis functions

The coordination of each of these operating strategies, for maximum benefit to customers and our own profitability, is a key factor differentiating Mass Merchandisers from other service merchandisers. Our integrated approach to implementing these strategies helps us provide high service levels while maintaining our position as a low-cost distributor.

Price labels are printed at each of our warehouses — slower moving items in Harrison and for faster moving items in Ozark, Alabama — one of MMI's satellite warehouses

Financial Review

Significant changes were made in the financial structure of the Company in the past year. Most of the changes resulted from the corporate reorganization in May 1984, which set Mass Merchandisers on an independent course to pursue its corporate objectives. Record revenues and earnings and measures to improve the strategic positioning of the Company for future growth also impacted Mass Merchandisers' financial position in 1984.

Corporate Reorganization
In May 1984 Mass Merchandisers, Inc. (MMI) became an independent publicly-owned company through the reorganization of its predecessor company, Napco Industries, Inc. The separation was accomplished through the spinoff to shareholders of the Company's only other operating unit, Napco International Inc., a distributor of defense products to foreign governments. Shareholders of record on May 1, 1984 received one share of Napco International for each five shares held of Napco Industries.

Immediately following the spinoff, the Company's wholly-owned subsidiary, Mass Merchandisers, Inc. was merged into the parent corporation. The change of the company name from Napco Industries, Inc. to Mass Merchandisers, Inc. completed the reorganization and preserved the identity of the Company's main business.

The reorganization changed the financial composition of the Company, since Napco International's assets, liabilities and capital structure were removed from the previously consolidated entity. One of the assets of the spun-off firm was 676,000 newly-issued shares of the parent firm. This 10 percent investment of Napco International in MMI was an integral component of the reorganization, deemed necessary to strengthen the financial structure of the spun-off firm.

The graphs included in this section depict certain elements of MMI's financial condition on a continuing operations basis and on a total historical basis.

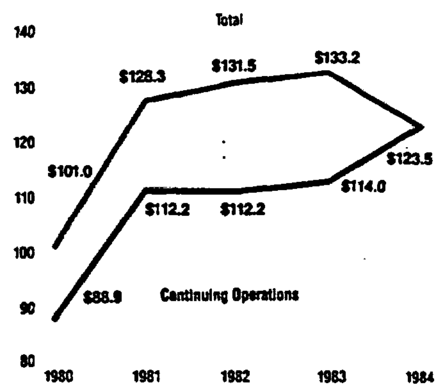
Performance Objectives
Mass Merchandisers is a growth-oriented company and management evaluates the Company's performance by how its business performs relative to its profitability and growth objectives and its long-term strategic plans.

Management's major focus is on achieving an above-average return on stockholders' equity. For 1984 the return on average stockholders' equity (ROE) was 12.9 percent for continuing operations. This ROE result was affected somewhat by the restructuring of the Company's capitalization in the reorganization. The Company's objective is to achieve a 16-18 percent return on equity in the near future and all levels of management are attentive to this primary goal.

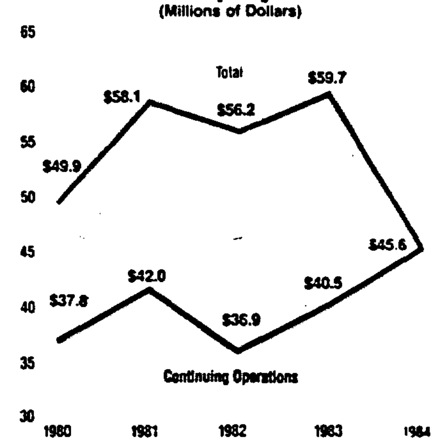
To increase ROE, the specific focus is on achieving higher margins and speeding the turnover of assets. Management has defined areas of margin improvement and of greater asset utilization and is concentrating on productivity improvements, expense controls and other efforts to achieve its overall goals.

An important aspect of increasing margins and turnover is the Company's growth objectives. The corporate objective is to achieve a 15-20 percent rate of growth in revenues and earnings over the next several years. This

Total Assets
(Millions of Dollars)



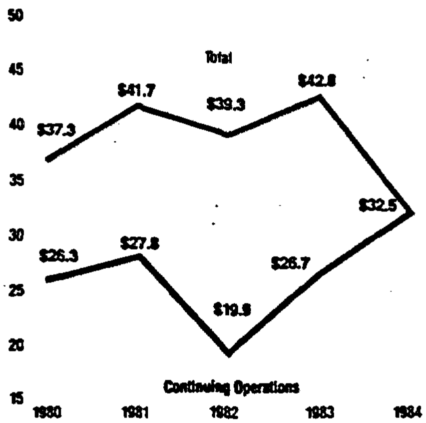
Total Stockholders' Equity
(Millions of Dollars)



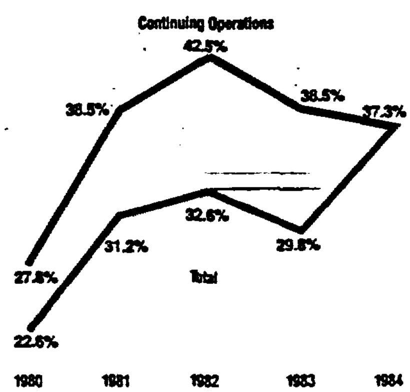
...m., Wednesday
Ozark, Alabama

growth rate could be further enhanced by acquisitions. For specific elements of MMI's growth strategy see pages 4-6 of this report.

Working Capital
(Millions of Dollars)



% Long Term Debt to Total Capitalization



• Dividend Policy — Mass Merchandisers has experienced rapid growth over the last several years and intends to continue in a high-growth mode. Because of this philosophy, management believes MMI's common shareholders are best served by the Company reinvesting a major portion of its earnings in the business.

Since 1975, however, continuing and increasing cash dividends have been paid to common shareholders. Because of the separation of the Company in May 1984 and its reduced capital structure and business base, the quarterly dividend rate was adjusted from 6 cents to 4 cents per share. The difference of 2 cents per share was thereafter paid by the spun-off company.

In January 1985 the board of directors approved an increase in the quarterly cash dividend to 5 cents per common share from 4 cents. The increase applies to the first quarter dividend payable March 29, 1985. The board of directors will continue to review dividend payments on a quarterly basis.

Financial Strength and Flexibility

• Liquidity — MMI's cash and working capital position at December 31, 1984 was significantly affected by operations and the reorganization in 1984.

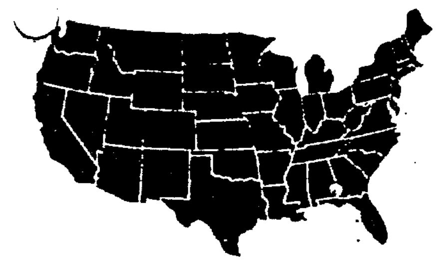
Cash flow from continuing operations, (net earnings plus noncash charges and changes in working capital items) totaled $5.5 million compared with $13.0 million in 1983. The higher 1983 amount was favorably affected by the collection of a $5.7 million income tax recoverable balance outstanding at the end of 1982 and by a $1.9 million increase in accounts payable and accrued expenses net of inventory change in that year. Record earnings from continuing operations were $5.5 million in 1984, up 46 percent from $3.8 million in 1983. Depreciation and amortization expense totaled $5.0 million compared with $5.2 million in 1983. Receivables were up $.8 million, or 2 percent and inventories net of accounts payable and accrued expenses increased $4.7 million.

To effect the balance sheet restructuring in the reorganization and to settle intercompany borrowings, MMI paid Napco International $3.9 million in 1984. In addition, $4.1 million of long-term debt associated with one term lender was retired at the time of the reorganization.

Working capital totaled $32.5 million at December 31, 1984 compared with $26.7 million and $19.9 million at the end of 1983 and 1982 on a continuing operations basis. The current ratio was 1.70 to 1 at the end of 1984 compared with 1.59 to 1 and 1.44 to 1 at the end of 1983 and 1982.

• Capital Resources — MMI's growth requires ongoing additions to working capital and distribution equipment. Periodic expansion of warehouse facilities is also required. Working capital growth requirements and some capital expenditures are financed primarily through operating cash flow and through seasonal short-term bank borrowings. MMI had total short-term bank lines of $12.5 million at December 31, 1984 of which $7.3 million was outstanding.

An MMI employee in the Ozark warehouse fills the [illegible] pricing the items as they are placed in a plastic "tote box."



In May 1984 long-term revolving credit lines were obtained from three banks, which permit aggregate borrowings of up to $15 million. At December 31, 1984, $7.0 million was borrowed under these long-term facilities.

Major capital expenditures and distribution center expansions normally require additions to long-term debt. The Company funds major warehouse expansions through Industrial Revenue Bond financings when available.

In 1984 MMI completed a 110,000 square-foot expansion of its Ozark, Alabama facility. The $2 million project which doubled the size of that distribution center was financed through the sale of Industrial Revenue Bonds at an interest rate of 9.75 percent.

Currently, the Company has under construction a 200,000 square-foot warehouse facility within its headquarters distribution center complex in Harrison, Arkansas. This $4 million expansion should be completed in mid-1985. Long-term debt financing alternatives for this facility are presently under consideration.

The 1985 budget for capital expenditures is $8 million, including the $4 million warehouse expansion. The remainder of the expenditures is principally for data processing and transportation equipment.

Acquisitions remain a part of MMI's growth strategy. Previous acquisitions have been completed through a combination of cash and the Company's common stock. Future acquisitions will be financed similarly, with stock being considered primarily when the selling principals are to remain with the business.

The Company considers a 50 percent long-term debt to total capitalization ratio as the maximum amount of leverage and risk it would choose to retain. At December 31, 1984, long-term debt to total capitalization was 37.2 percent compared with 38.5 percent and 42.5 percent at the end of 1983 and 1982 on a continuing operations basis.

• Impact of Inflation — MMI's inventories are conservatively valued using the LIFO method, so operating performance is based consistently on current costs. Price increases from vendors are passed on to customers as they occur. It should be noted that both 1984 and 1983 were years of low inflation. The LIFO provision was $1.6 million, $.1 million, and $1.3 million in 1984, 1983 and 1982, respectively. As to fixed assets, MMI's distribution centers are all relatively new so that their recorded values are near current replacement cost.

Summary and Analysis of Operations

1984

Net revenues in 1984 were $326.3 million, an increase of $47.8 million or 17.2 percent over 1983. The increase was mainly attributable to the expansion of the Company's customer base, a combination of new customers and additional categories sold to existing accounts. Geographically, the largest expansion was in the southern and southeastern regions, although other regions in the Company's market area showed general increases as well. Price increases, which related primarily to increased prices from vendors passed on to customers, contributed less than 4 percent of the revenue increase.

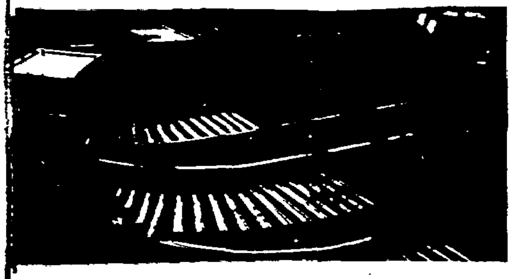
Cost of products sold as a percentage of net revenues was 74.9 percent in 1984, up .9 percent from 1983. The 1984 decrease in gross margins resulted from a higher volume of promotional sales, a small shift in the overall sales mix to "lower service level" programs, and a higher percentage of health and beauty aid sales versus generally higher-margin general merchandise items. Both of the above mix changes were due to the type of new accounts added in 1984 and are not considered indicative of any general trend in the business.

Operating expenses totaled $68.5 million in 1984, a 10.2 percent increase over 1983. As a percent of net revenues, however, these expenses were 21.0 percent in 1984 compared with 22.3 percent in the prior year. The improvement resulted primarily from administrative expense areas, which are less variable in their relationship with net revenues.

Interest expense was $2.9 million in 1984, 4.7 percent less than in 1983. The decrease was due to lower short-term interest rates.

The 1984 effective income tax rate was 47.5 percent, comparable with the prior year's rate.

Discontinued operations represents the results of the interna-



...m., Wednesday
Ozark, Alabama

tional marketing segment, Napco International Inc., which was spun off to shareholders on May 1, 1984. Accordingly, 1984 includes only four months of its results.

1983

Net revenues totaled $278.5 million in 1983, 4 percent greater than in 1982. Eliminating the impact of the Reno, Nevada operation which was closed in early 1983, revenues rose 14 percent. Increases were mainly due to internal growth through the expansion of MMI's customer base and to a reduction in sales returns and allowances. Price increases contributed less than 2 percent.

Cost of products sold as a percentage of net revenues was 74.0 percent, unchanged from 1982.

Operating expenses of $62.1 million in 1983 decreased 9.9 percent from 1982. As a percentage of net revenues, these expenses were 22.3 percent in 1983 compared with 25.9 percent in 1982. The significant reduction resulted from lower staff levels, tighter budgetary controls and the closing of the Reno operation. Expenses were reduced in every category with warehousing and delivery expenses decreasing the greatest percentage — 21.9 percent.

Interest expense was $3.0 million in 1983, 24.9 percent less than in 1982. The decrease was due to better asset management which resulted in significantly lower average borrowings.

1982

In 1982, net revenues were 13 percent higher than in 1981. This increase resulted primarily from MMI's expansion into the western U.S. in the later months of 1981. MMI's now closed Reno, Nevada distribution center accounted for $26 million of 1982 revenues, up from $3 million in 1981.

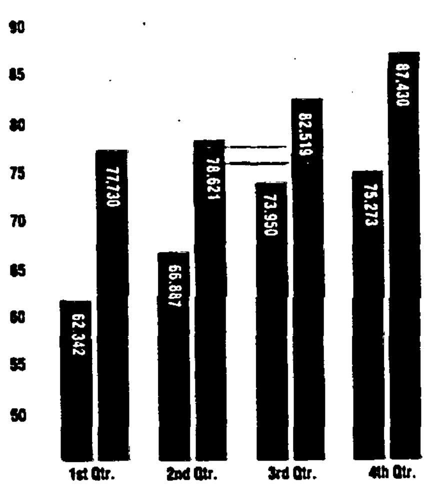
Gross margins in 1982 decreased by 2.4 percent from 1981. A major factor contributing to the 1982 decrease was the lower margin sales of the Reno distribution center, when compared with the overall company product mix.

Operating expenses totaled $69.0 million in 1982, 25.9 percent of sales compared with 25.3 percent of sales in 1981. High expense levels of the Reno operation plus expenses to start up two new distribution centers in MMI's central network and costs to close three other less efficient warehouses also caused higher operating expenses in 1981 and 1982.

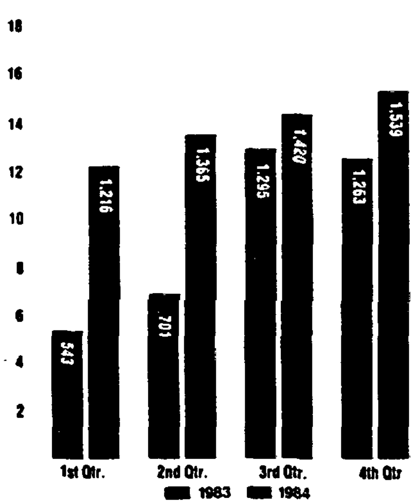
Nonrecurring charges of $6.0 million included: $2.1 million relating to a stock keeping unit (SKU) reduction program and other inventory reductions, $.7 million relating to losses on nonproductive leased assets; and $3.2 million relating to warehouse closing costs.

Interest expense in 1982 totaled $4.0 million, up 6.7 percent from 1981. The increase resulted from long-term financings in 1981 for acquisitions and capital expenditures. In addition, in 1982 the Company had higher levels of short-term borrowings.

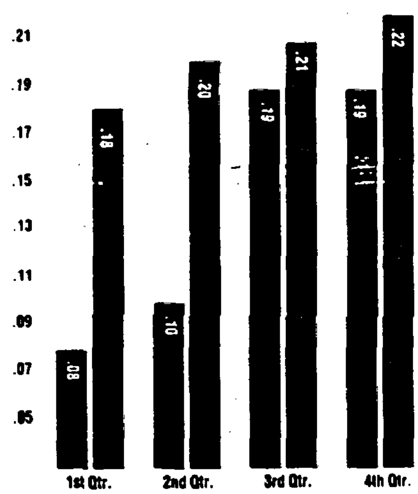
Net Revenues
(Dollars in Thousands)



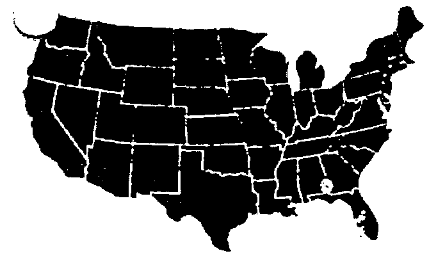
Net Earnings from Continuing Operations
(Dollars in Thousands)



Net Earnings per Share from Continuing Operations



The customer's order is brought together from the [illegible]s order filling lines and consolidated with the slow moving items delivered from Harrison where they were picked the previous day



Five Year Earnings and Financial Summary
Mass Merchandisers, Inc. and Subsidiaries

	1984	1983	1982	1981	1980
		(Dollars in thousands except per share data)			
Earnings information:					
Net revenues from continuing operations	**$326,300**	$278,452	$266,720	$236,325	$168,874
Cost of products sold and operating expenses	**312,874**	268,222	272,317 (a)	228,921	162,954
Interest expense	**2,873**	3,015	4,015	3,764	1,576
Earnings (loss) from continuing operations before income taxes	**10,553**	7,215	(9,612)	3,640	4,344
Net earnings (loss) from continuing operations	**5,540**	3,802	(4,356)	3,241	2,480
Net earnings (loss)	**5,498**	4,183	(642)	7,595	15,954 (b)
Per common share data: (c)					
Earnings (loss) from continuing operations	**.81**	.56	(.67)	.49	.40
Net earnings (loss)	**.81**	.62	(.10)	1.16	2.63 (b)
Cash dividends	**.174**	.216	.216	.185	.145
Equity per share — continuing operations	**6.55**	5.91	5.45	6.25	5.75
— total	**6.55**	8.78	8.38	8.69	7.65
% Return on equity — continuing operations	**12.9**	9.8	(11.0)	8.1	9.7 (d)
— total	**10.4**	7.2	(1.1)	14.1	15.2 (d)
Financial position:					
Total assets — continuing operations	**123,452**	114,002	112,155	112,245	88,862
— total	**123,452**	133,230	131,482	128,331	100,995
Additions to property and equipment	**5,974**	1,251	11,083	17,402	5,230
Long-term debt at year end	**27,065**	25,386	27,209	26,285	14,562
Stockholders' equity at year end					
— continuing operations	**45,581**	40,510	36,870	41,999	37,761
— total	**45,581**	59,738	56,197	58,085	49,894
% Long-term debt to total capitalization					
— continuing operations	**37.3**	38.5	42.5	38.5	27.8
— total	**37.3**	29.8	32.6	31.2	22.6
Other stockholder data: (e)					
Market price range — high	**14.00**	16.88	17.00	17.33	15.92
— low	**7.50**	9.50	7.63	11.33	5.87
Common shares outstanding (000's)	**6,814**	6,694	6,593	6,569	6,402

(a) The amount shown for 1982 included nonrecurring charges of $[illegible] million for warehouse consolidation [illegible]

(b) The 1980 net earnings included a $9.8 million gain on sale of a subsidiary, or $1.62 per share

(c) Per share data has been adjusted for the [illegible] shares issued in the Mar. 1, 1984 corporate [illegible] declared in 1981 and the [illegible] split effected during 1980

(d) The calculation excludes the effect of the $9.8 million gain on sale of a subsidiary

(e) Adjusted for stock splits

[illegible]noon, Wednesday
Ozark, Alabama

Quarterly Financial Data
(Unaudited)

	First Quarter		Second Quarter		Third Quarter		Fourth Quarter	
	1984	1983	**1984**	1983	**1984**	1983	**1984**	1983
	(Dollars in thousands except per share data)							
Net revenues (a)	**$77,730**	$62,342	**$78,621**	$66,887	**$82,519**	$73,950	**$87,430**	$75,273
Gross profit (a)	**19,692**	16,416	**20,333**	16,913	**20,497**	18,487	**21,378**	20,546
Net earnings (loss) (a)								
Continuing operations	**1,216**	543	**1,365**	701	**1,420**	1,295	**1,539**	1,263
Discontinued operations	**125**	136	**(167)**	320	**—**	(211)	**—**	136
	1,341	679	**1,198**	1,021	**1,420**	1,084	**1,539**	1,399
Net earnings (loss) per share (a)(b)								
Continuing operations	**.18**	.08	**.20**	.10	**.21**	.19	**.22**	.19
Discontinued operations	**.02**	.02	**(.02)**	.05	**—**	(.03)	**—**	.02
	.20	.10	**.18**	.15	**.21**	.16	**.22**	.21
Dividends per common share (b)	**.054**	.054	**.040**	.054	**.040**	.054	**.040**	.054
Market price range per common share (c)								
High	**14.00**	11.50	**12.13**	16.88	**11.63**	15.75	**12.38**	14.13
Low	**9.63**	9.50	**7.50**	11.00	**8.00**	11.63	**10.50**	12.63

(a) Data for 1983 and the first quarter of 1984 has been restated [illegible] discontinued operations.
(b) Net earnings and dividends per share prior to May 1, 1984 [illegible] shares issued [illegible] Napco International Inc. in the corporate reorganization.
(c) Stock prices are based upon the actual high and low closing sales prices of Mass Merchandisers, Inc. [illegible] (MMS) beginning May 14, 1984 and Napco Industries Inc. common stock (symbol NAP) prior to May 14, 1984.

Auditors' Report

Alexander Grant & COMPANY
CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors and Shareholders
Mass Merchandisers, Inc.

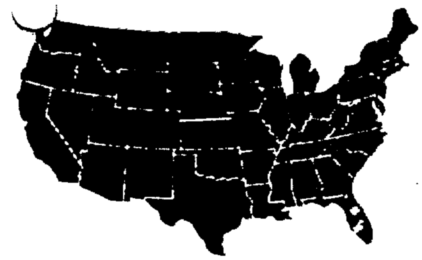
We have examined the consolidated balance sheets of Mass Merchandisers, Inc. (an Indiana corporation) and Subsidiaries as of December 31, 1984 and 1983, and the related consolidated statements of earnings, changes in stockholders' equity and changes in financial position for each of the three years in the period ended December 31, 1984. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of Mass Merchandisers, Inc. and Subsidiaries at December 31, 1984 and 1983, and the consolidated results of their operations and changes in their financial position for each of the three years in the period ended December 31, 1984, in conformity with generally accepted accounting principles applied on a consistent basis.

Alexander Grant & Company

St. Louis, Missouri
January 30, 1985

Customer orders are loaded into a semi-trailer destined for Tampa, Florida where our truck driver will deliver the order to one of MMI's subwarehouses during the night.



Consolidated Statements of Earnings
Mass Merchandisers, Inc. and Subsidiaries

	Years ended December 31,		
	1984	1983	1982
		(in thousands, except per share data)	
Net revenues	**$326,300**	$278,452	$266,720
Costs and expenses			
Cost of products sold	**244,400**	206,090	197,389
Warehousing and delivery	**16,356**	14,489	18,561
Marketing	**32,017**	27,078	29,117
Administrative	**20,101**	20,565	21,294
Nonrecurring charges	**—**	—	5,956
Interest	**2,873**	3,015	4,015
	315,747	271,237	276,332
Earnings (loss) from continuing operations before income taxes	**10,553**	7,215	(9,612)
Income taxes (benefit)	**5,013**	3,413	(5,256)
Net earnings (loss) from continuing operations	**5,540**	3,802	(4,356)
Net earnings (loss) from discontinued operations	**(42)**	381	3,714
NET EARNINGS (LOSS)	**$ 5,498**	$ 4,183	$ (642)
Net earnings (loss) per share			
Continuing operations	**$ .81**	$ .56	$ (.67)
Discontinued operations	**—**	.06	.57
	$ .81	$ .62	$ (.10)

See accompanying notes to consolidated financial statements

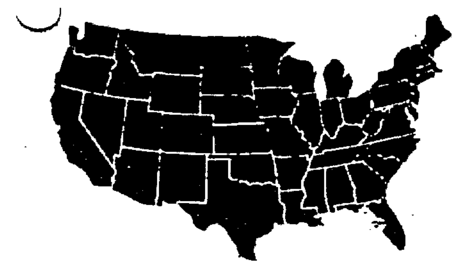
7 a.m., Thursday
Tampa, Florida

Consolidated Balance Sheets
Mass Merchandisers, Inc. and Subsidiaries

	December 31, 1984	December 31, 1983
ASSETS	(in thousands)	
Current assets		
Cash	**$ 2,557**	$ 516
Accounts receivable, less allowance for doubtful accounts of $293,000 in 1984 and $220,000 in 1983	**33,144**	32,382
Inventories	**42,881**	38,992
Prepaid expenses	**711**	267
Net current assets of discontinued operations	—	16,048
Total current assets	**79,293**	88,205
Property and equipment		
Land	**2,040**	1,917
Buildings and leasehold improvements	**20,641**	18,993
Warehouse and office equipment	**27,557**	24,655
Transportation equipment	**5,891**	5,287
	56,129	50,852
Accumulated depreciation and amortization	**19,182**	15,126
	36,947	35,726
Other assets		
Excess cost of assets acquired over underlying net asset value	**3,034**	3,150
Net long-term assets of discontinued operations	—	3,180
Other	**4,178**	2,969
	$123,452	$133,230
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Notes payable to banks	**$ 7,270**	$ —
Current maturities of long-term debt	**1,079**	1,799
Accounts payable	**30,552**	30,915
Accrued liabilities	**7,205**	7,634
Payable to former affiliate	—	3,947
Income taxes	**653**	1,152
Total current liabilities	**46,759**	45,447
Long-term debt, less current maturities	**27,065**	25,386
Deferred income taxes and other credits	**4,047**	2,659
Commitments	—	—
Stockholders' equity		
5% cumulative ~~preferred~~ stock — $35 par value	**628**	628
$.25 cumulative non-par preferred stock	**158**	158
Common stock — $1 par value	**6,911**	6,162
Additional contributed capital	**6,576**	19,608
Retained earnings	**31,574**	33,499
	45,847	60,055
Less common stock in treasury, at cost	**(266)**	(317)
	45,581	59,738
	$123,452	$133,230

See accompanying notes to consolidated financial statements

At the subwarehouse, orders await delivery to customers within the next three days. MMI's sales person picks up this customer's order for delivery that same day.

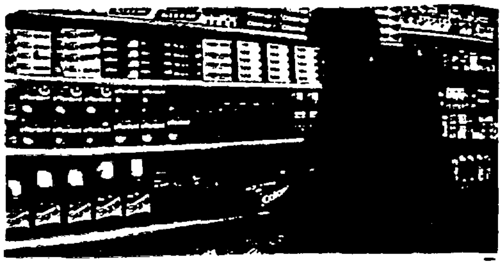


Consolidated Statements of Changes in Stockholders' Equity

Mass Merchandisers, Inc. and Subsidiaries
Three years ended December 31, 1984

	Common Stock	Additional Contributed Capital	Retained Earnings	Treasury Stock
		(in thousands)		
Balance at December 31, 1981	**$6,096**	**$18,656**	**$32,910**	**$(363)**
Net loss for 1982	—	—	(642)	—
Less cash dividends				
Preferred stock	—	—	(47)	—
Common stock at $.22 per share	—	—	(1,419)	—
Employee stock purchase rights, options and awards	31	124	—	—
Other	—	99	—	(34)
Balance at December 31, 1982	**6,127**	**18,879**	**30,802**	**(397)**
Net earnings for 1983	—	—	4,183	—
Less cash dividends				
Preferred stock	—	—	(47)	—
Common stock at $.22 per share	—	—	(1,439)	—
Employee stock purchase rights, options and awards	35	436	—	55
Contributions of treasury stock to Profit Sharing Trust	—	331	—	79
Other	—	(38)	—	(54)
Balance at December 31, 1983	**6,162**	**19,608**	**33,499**	**(317)**
Net earnings for 1984	—	—	5,498	—
Less cash dividends				
Preferred stock	—	—	(47)	—
Common stock at $.17 per share	—	—	(1,180)	—
Shares issued in reorganization	676	5,520	(6,196)	—
Equity distributed in reorganization	—	(19,066)	—	—
Reorganization costs	—	(261)	—	—
Employee stock purchase rights, options and awards	73	761	—	141
Purchases of treasury stock	—	—	—	(89)
Other	—	14	—	(1)
Balance at December 31, 1984	**$6,911**	**$ 6,576**	**$31,574**	**$(266)**

See accompanying notes to consolidated financial statements



0 a.m., Thursday
Lakeland, Florida

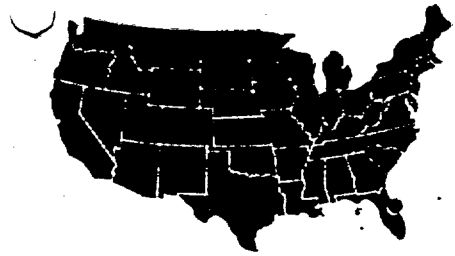
Consolidated Statements of Changes in Financial Position

Mass Merchandisers, Inc. and Subsidiaries

	Years ended December 31,		
Cash provided (used) by	1984	1983	1982
Continuing operations		(in thousands)	
Net earnings (loss)	**$ 5,540**	$ 3,802	$ (4,356)
Charges to earnings not using cash			
Depreciation and amortization	**4,996**	5,190	4,504
Deferred taxes and other credits	**1,388**	20	1,389
(Increase) decrease in			
Accounts receivable	**(762)**	(5,107)	4,334
Inventories	**(3,889)**	(7,567)	6,593
Prepaid expenses	**(444)**	300	(124)
Income taxes recoverable	**—**	5,715	(5,715)
Increase (decrease) in			
Accounts payable and accrued expenses	**(792)**	9,506	(14)
Income taxes	**(499)**	1,152	(621)
Cash provided by continuing operations	**5,538**	13,011	5,990
Discontinued operations			
Net earnings (loss)	**(42)**	381	3,714
(Increase) decrease in net assets	**162**	99	(3,241)
Net assets distributed in spinoff	**19,066**	—	—
	19,186	480	473
Investing transactions			
Additions to property and equipment	**(5,974)**	(1,251)	(11,083)
Other — net	**(1,336)**	1,008	1,587
	(7,310)	(243)	(9,496)
Financing and equity transactions			
Proceeds from notes payable to banks	**7,270**	—	—
Proceeds from long-term debt	**9,000**	—	2,560
Repayment of long-term debt	**(8,041)**	(1,017)	(1,485)
Increase (decrease) in payable to former affiliate	**(3,947)**	(11,455)	3,208
Issuance of common stock	**548**	897	156
Issuance of treasury stock	**440**	—	—
Purchase of treasury stock	**(89)**	(53)	(33)
Cash dividends	**(1,227)**	(1,486)	(1,466)
Reorganization costs	**(261)**	—	—
Equity distributed in spinoff	**(19,066)**	—	—
	(15,373)	(13,114)	2,940
Increase (decrease) in cash	**$ 2,041**	$ 134	$ (93)

See accompanying notes to consolidated financial statements

Our sales person restocks the store's shelves before ordering more merchandise.



Notes to Consolidated Financial Statements

Mass Merchandisers, Inc. and Subsidiaries

Note A — Summary of Significant Accounting Policies

A summary of the Company's significant accounting policies consistently applied in the preparation of the accompanying financial statements follows.

1. **Principles of consolidation** — The consolidated financial statements include the accounts of Mass Merchandisers, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.
2. **Inventories** — Inventories are stated at the lower of cost or market. Cost is determined principally by using the last-in, first-out (LIFO) method. If inventory values were shown at current cost (approximated by the first-in, first-out method) rather than at LIFO values, inventories would have been higher by $6,595,000 and $4,991,000 at the end of 1984 and 1983, respectively.
3. **Property and equipment** — Depreciation and amortization are provided for in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives. Depreciation is computed for financial reporting and tax purposes using both accelerated and straight-line depreciation methods. The ranges of service lives being used are as follows:

Buildings	15 to 40 years
Warehouse and office equipment	7 to 15 years
Furniture and fixtures	5 to 10 years
Transportation equipment	3 to 7 years
Leasehold improvements	5 to 20 years

4. **Intangibles** — The excess cost of net assets acquired over the fair value of the net assets at date of acquisition is being amortized by the straight-line method over forty years. Accumulated amortization at December 31, 1984 and 1983 was $635,000 and $520,000, respectively.
5. **Income taxes** — Deferred income taxes are provided for the effect of timing differences in reporting transactions for financial and tax purposes. Income tax credits are accounted for by the "flow-through" method which recognizes the credits as reductions of income tax expense in the year utilized.
6. **Pension plans** — The Company has in effect two noncontributory pension plans covering substantially all of its employees. Charges to operations include normal cost plus amortization of unfunded past service cost over twenty years. The Company's policy is to fund pension costs accrued.
7. **Earnings per common share** — Earnings per common share are computed after preferred dividend requirements and are based on the weighted average outstanding common shares, and when dilutive, common share equivalents. Weighted average shares outstanding were 6,769,000, 6,659,000 and 6,584,000 in 1984, 1983 and 1982 respectively. Restatements of earnings per share have been made for the 676,000 new shares issued in the May 1, 1984 corporate reorganization (see Note B).
8. **Accounts Payable** — Accounts payable include outstanding checks, net of deposits in transit, to the extent necessary to restore operating cash account balances to zero.

Note B — Corporate Reorganization

A corporate reorganization was completed effective May 1, 1984. Under the reorganization, the net assets of the international marketing segment of Napco Industries, Inc. (Napco) were spun off to a new corporation, Napco International Inc. (International). In addition, 676,000 new Napco common shares were distributed to International. New International common shares were in turn distributed pro rata to Napco shareholders. On May 10, 1984, Napco shareholders approved a Company name change from Napco Industries, Inc. to Mass Merchandisers, Inc. (MMI).

International has agreed to dispose of the 676,000 shares of MMI received in the reorganization within five years. Further, it has agreed to vote such shares in the same proportion as the aggregate voting of the other MMI shareholders.

The spinoff of the international marketing segment has been recorded as discontinued operations in the accompanying statements. The fair market value of the 676,000 newly issued shares was transferred from retained earnings to permanent capital; dividends and earnings per share calculations were retroactively restated for all periods presented. Costs incurred in connection with the reorganization and the book value of the net assets transferred have been charged against additional contributed capital.

Net revenues of the discontinued operations were $16.2 million for the four months ended April 30, 1984 and were $45.7 million and $61.9 million for the years 1983 and 1982, respectively.

Note C — Long-Term Debt

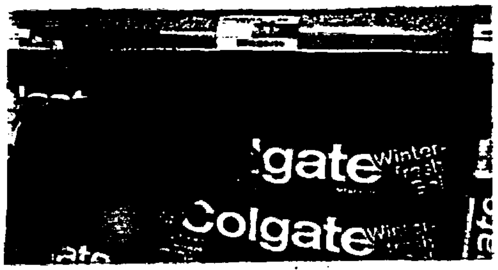
Long-term debt at December 31 of each year consisted of the following:

	1984	1983
	(in thousands)	
Revolving credit loans	$ 7,000	$ —
9.4% unsecured term loan	—	4,550
Capitalized lease obligations (Note D)	20,196	21,175
Other	948	1,460
	28,144	27,185
Less current maturities	1,079	1,799
	$27,065	$25,386

On May 1, 1984 the Company secured revolving credit agreements with three banks which allow the Company to borrow a total of $15.0 million priced using alternative rate structures at or below the prime rate, for a period through April 1988. At that time, borrowings may be converted to term loans with interest no greater than 1/4 of 1 percent above prime payable in quarterly installments over three years. The Company is required to pay commitment fees of 3/8 percent per annum on the unused portions of the lines.

On April 30, 1984, the Company prepaid the remainder of the 9.4 percent term loan to facilitate the corporate reorganization.

Under the terms of loan agreements the Company is subject to certain restrictive covenants which include, among other things, the maintenance of working capital and net worth; limitations on the incurrence of additional debt and long-term lease obligations; the payment of dividends and



a.m., Thursday
Billings, Montana

purchase or redemption of capital stock. Under the terms of the agreements, at December 31, 1984 and 1983 retained earnings in the amount of $7.5 million and $3.8 million, respectively, were unrestricted and thus available for payment of cash dividends or for the purchase and redemption of the Company's capital stock.

Scheduled payments of long-term debt for the years 1985 through 1989 are as follows (thousands of dollars):

1985	$1,079
1986	1,177
1987	1,220
1988	2,227
1989	3,416

The total amount of interest cost incurred by the Company's continuing operations was $2,943,000 during 1984, $3,015,000 during 1983 and $4,256,000 during 1982 of which $70,000 was capitalized during 1984 and $241,000 in 1982.

Note D — Lease Commitments

The Company conducts a portion of its operations using leased properties. Certain leased properties were financed through Industrial Revenue Bonds and have been capitalized. The Company has the option to purchase the properties at nominal costs upon expiration of the leases. Under the terms of these leases, the Company is subject to certain restrictive covenants which include, among other things, the maintenance of working capital and net worth and limitations on the incurrence of additional debt. The cost of all properties under capitalized leases (principally buildings and equipment) was $21,427,000 at December 31, 1984 and $22,130,000 at December 31, 1983. Related accumulated amortization was $4,872,000 and $4,289,000 respectively. The leases are noncancelable and expire on various dates through the year 2001.

Following is a schedule by years of future minimum payments under capital leases and operating leases, excluding minimum sublease rentals of $2,326,000 due in future years under noncancelable subleases. Capital leases include interest at varying rates from 6.0 percent to 10.5 percent, with a weighted average of 9.6 percent.

Year Ending December 31,	Capital Leases	Operating Leases
	(in thousands)	
1985	$ 2,543	$1,213
1986	3,282	1,078
1987	3,363	854
1988	3,136	930
1989	3,065	910
Thereafter	28,860	839
	$44,249	$5,824
Less amount representing interest	24,053	
Capitalized lease obligations at December 31, 1984	$20,196	

Total rental expense incurred by continuing operations for the years ended December 31, 1984, 1983 and 1982, including amounts paid under short-term leases, was $3,238,000, $3,017,000 and $5,668,000, respectively.

Note E — Income Taxes

Income tax expense (benefit) for each of the last three years differed from the expected amount computed by applying the marginal Federal income tax rate of 46 percent against pretax earnings (loss). The reasons for the differences were as follows:

	1984	1983	1982
		(in thousands)	
Computed "expected" tax expense — 46%	$4,854	$3,319	$(4,422)
Increases (decreases) resulting from:			
Investment tax credits	(307)	(64)	(792)
State income taxes, net of federal benefit	314	81	86
Other	152	77	(128)
Actual tax expense (benefit)	$5,013	$3,413	$(5,256)

The components of income tax expense are as follows:

	1984	1983	1982
		(in thousands)	
Currently payable (refundable):			
Federal	$3,522	$1,803	$(5,106)
State	581	150	159
Deferred	910	1,460	(309)
	$5,013	$3,413	$(5,256)

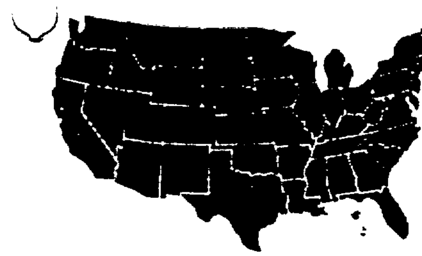
Deferred taxes relate principally to depreciation and the nonrecurring warehouse consolidation and related costs discussed in Note I. Income taxes related to discontinued operations in 1982 were $1,522,000 and were immaterial in 1983 and 1984.

Note F — Stockholders' Equity

The Company has 10 million shares of authorized common stock with 6,910,975 shares and 6,838,263 shares issued at the end of 1984 and 1983, respectively (after giving effect to the 675,933 shares issued to Napco International Inc. in connection with the corporate reorganization — Note B). Common stock held in treasury at the end of 1984 and 1983 was 97,290 shares and 143,923 shares, respectively. The Company has authorized and outstanding 17,954 shares of 5 percent cumulative preferred stock with par value of $35 and 63,364 shares of $.25 cumulative non-par preferred stock.

The Company has both incentive stock option and non-incentive stock option plans providing participating employees the right to purchase common stock of the Company. The options are exercisable over a ten-year period. The options are granted at a price equal to 100 percent of the market price of the stock at the date of grant and, therefore, since both the number of shares under option and the option price are fixed, no compensation expense is recorded by the Company. A summary of stock option transactions during the two years ended December 31, 1984 follows:

Another consumer in Billings, Montana makes a [illegible]ase and again the order cycle begins.



	Number of Shares	Option Price Per Share
Stock options outstanding		
At December 31, 1982	347,377	$1.07-15.33
Granted	115,500	7.88-11.75
Exercised	(35,593)	1.07-11.33
Canceled	(20,858)	6.22-11.33
At December 31, 1983	406,426	$1.07-15.33
Substitution		
Old options	(297,302)	1.07-15.33
New options	405,786	.81-11.23
Exercised	(72,712)	1.07-11.33
Canceled	(51,013)	5.87-11.75
At December 31, 1984	391,185	$0.81-11.23

Options outstanding at the date of the corporate reorganization were converted into new options for the Company's employees. The new option shares and prices were substituted for the old so as to maintain the same value of the options immediately after the corporate reorganization to that immediately before.

At December 31, 1984 and 1983, 114,904 and 63,891 shares, respectively, were available for the granting of options, and 279,376 and 206,776 options previously granted, respectively, were exercisable.

The Company has an Employee Stock Purchase Plan for its non-officer employees pursuant to which selected employees are granted the right to purchase shares of common stock from the Company at predetermined prices. The plan authorizes the issuance of up to 140,625 shares of common stock, of which 94,401 shares were issued as of December 31, 1984.

A Contributory Stock Purchase Plan exists for the benefit of employees of the Company and its subsidiaries. Under the plan, common stock is purchased on the open market with funds contributed 85 percent by the participants and 15 percent by the Company with the Company paying all brokerage fees. The plan enables eligible employees to acquire an ownership interest in the Company and share in its future. As of December 31, 1984, 306 employees were plan participants and 119,801 shares had been purchased under the plan.

Note G — Pension Plans

The total pension expense included in continuing operations for the years ended December ~~31, 1984, 1983 and~~ 1982 amounted to $764,000, $761,000 and $402,000, respectively. The accumulated plan benefits and plan net assets for all defined benefit plans, determined primarily as of January 1 of each year, are as follows:

	1984	1983
	(in thousands)	
Actuarial present value of accumulated plan benefits		
Vested	$2,736	$2,352
Nonvested	1,983	1,426
	$4,719	$3,778
Net assets available for benefits	$5,195	$4,096

The weighted average rate of return used in determining the actuarial present value of accumulated plan benefits was approximately 7 percent for both 1984 and 1983.

Included under Other Deferred Credits were $464,000 and $187,000 at December 31, 1984 and 1983, respectively, relating to deferred compensation agreements entered into in 1982 and 1983 with certain key employees. The agreements provide for monthly retirement benefit payments for 15 years following the employees' retirement. The Company has purchased life insurance policies with total annual premiums of $190,000 per year to fund the deferred compensation agreements. In turn, the employees have entered into salary reduction agreements so as to provide funding for the policies during the initial four policy years. Thereafter, premiums will be funded through borrowings against policy cash surrender values.

Note H — Payable to Former Affiliate

At December 31, 1983 the Company was indebted to its former affiliate for advances made in the normal course of business. At the time of the separation of Napco International Inc. from the Company, the obligation was paid and no future advances will be received or made. Net interest expense on these advances was $23,000, $447,000 and $2,058,000 in 1984, 1983 and 1982, respectively.

Note I — Nonrecurring Charges-Warehouse Consolidation

Included in the $6.0 million of warehouse consolidation and related costs for 1982 were the following charges: $2.1 million relating to a stock keeping unit (SKU) reduction program and other inventory reductions; $.7 million relating to losses on nonproductive leased assets; and $3.2 million relating to warehouse closings and related employee relocation costs.

On February 16, 1983, the Company's Board of Directors approved management's recommendation to close the Reno, Nevada warehouse in early 1983. Costs of closing the Reno warehouse and operating losses during the phase-down period prior to its closing were included in the total of $6.0 million of costs mentioned above. Actual costs incurred in 1983 exceeded the provision by a nominal amount.

Note J — Revenues

Revenues were derived exclusively from sales to U.S. customers. In 1984 and 1983 revenues included sales to one customer of $64.5 million and $46.0 million, respectively. No single customer's sales exceeded 10 percent of revenues in 1982.

a.m., Friday

The full cycle is complete when 5-year-old Shana Tetuan brushes her teeth. Shana is the daughter of MMI employee Cheryle Tetuan of Harrison, Arkansas.

Directors and Officers

1 Frank D. Trestman, 50, Chairman of the Board of Directors and Chief Executive Officer, was elected to that position in 1984. Mr. Trestman was President of Napco Industries, Inc., MMI's predecessor company, from 1974 to 1984.

2 J.D. Erwin, 49, President and Director, was named President and Chief Operating Officer in 1982, and was elected a Director in 1983. Mr. Erwin has been with Mass Merchandisers, Inc., and predecessor companies since 1956.

3 Erwin A. Kelen, 49, elected a director in 1968, is Chairman of the Compensation Committee. Mr. Kelen is Chairman and Chief Executive Officer of Data Myte Corporation.

4 Herbert S. Krasnow, 62, elected a Director in 1962, is a member of the Audit Committee. Mr. Krasnow is Chairman of Educational Computer Corp. He is a Partner in the New York investment firm, Lefferts/Fore Associates.

5 Richard S. Levitt, 54, Director since 1984, is a member of the Audit Committee. Mr. Levitt is Vice Chairman and Director of Norwest Corporation; Chairman of Norwest Financial ~~Services~~, Inc and Norwest Fin~~ancial, Inc.~~

6 Stephen E. Lieberman, 49, elected a Director in 1984, is a member of the Compensation Committee. Mr. Lieberman is President of Carousel Snack Bars, Executive Vice President of Lieberman Enterprises and President of Lieberman Music Company.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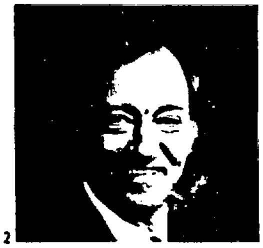
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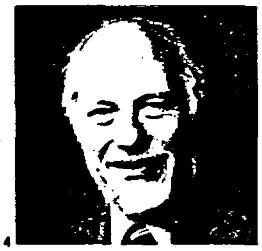
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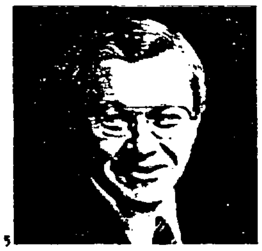
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7 George S. Sarlo, 47, Director since 1978, is a member of the Compensation Committee. Mr. Sarlo is Chairman of Ashfield and Co., Inc.

8 Jonathan L. Scott, 54, elected a Director in 1983, is chairman of the Audit Committee. Mr. Scott is Chairman and Chief Executive Officer of J.L. Scott Enterprises, Inc. He was former Vice Chairman and CEO of Albertsons, Inc. and later chairman and CEO of A & P.

9 Morris M. Sherman, 49, Secretary and General Counsel was elected a Director in 1984. Mr. Sherman is a Partner in the Minneapolis law firm, Leonard, Street and Deinard.

10 Stuart D. Braznell, 43, an officer since 1984, is Executive Vice President-Operations. He joined MMI in 1974.

11 Frank Conner, 35, an officer since 1981, is Executive Vice President-Finance and Information Systems. He joined MMI in 1980.

12 Bruce Connor, 39, an officer since 1984, is Executive Vice President-Sales. He joined MMI in 1979.

13 Robert L. Dickson, 38, an officer since 1984, is Executive Vice President-Purchasing and Merchandising. He joined MMI in 1978.

14 James P. Neve, Jr., 37, an officer since 1977, is Executive Vice President and Treasurer. He joined Napco, MMI's predecessor company, in 1972.

Corporate Headquarters
Highway 43 and Cottonwood Road
P.O. Box 790
Harrison, Arkansas 72601
(501) 741-3425

Form 10-K Available
The Form 10-K Annual Report to the Securities and Exchange Commission provides certain additional information and may be obtained upon request to the Treasurer of the Company.

Annual Meeting
The Annual Meeting of Mass Merchandisers shareholders will be held at 3:30 p.m. on Thursday, May 23, 1985 at the Company's corporate headquarters in Harrison, Arkansas.

Registrar and Transfer Agent
J. Henry Schroder Bank & Trust Company
1 State Street
New York, New York 10015

Auditors
Alexander Grant & Company
222 S. Central Avenue
St. Louis, Missouri 63105

Common Stock
Mass Merchandisers, Inc.
Common Stock is traded on the New York Stock Exchange (Symbol MMS).

Distribution Centers
Harrison, Arkansas
Lincoln, Nebraska
Ozark, Alabama
Seattle, Washington

Mass Merchandisers, Inc.

BOX 790, HARRISON, ARKANSAS 72601

AMERICA'S

VICE MERCHANDISER